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25 May 2020

Dear Sir,

Exposure Draft ED/2020/1 Interest Rate Benchmark Reform - Phase 2

We are pleased to comment on the above Exposure Draft (the ED). Following consultation with the BDO network[1], this letter summarises views of member firms that provided comments on the ED.

We are supportive of the proposals set out in the ED to address financial reporting issues that arise as a result of the replacement of interest rate benchmarks with alternative benchmark rates. We are of the view that the proposals will result in providing more useful information to users of financial statements.

We also support the Board's approach to limit the scope of the proposals in the ED for modifications of financial assets and financial liabilities to modifications as a result of interest rate benchmark reform only. Our responses to the questions in the ED are set out in the attached Appendix.

We hope that you will find our comments and observations helpful. If you would like to discuss any of them, please contact me at +44 (0)20 7893 3300 or by email at abuchanan@bdoifra.com.

Yours faithfully

Andrew Buchanan

Global Head of IFRS

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Appendix

Question 1—Modifications of financial assets and financial liabilities (paragraphs 6.9.1–6.9.6 of the [Draft] amendments to IFRS 9, paragraphs 20R–20S and 50–51 of the [Draft] amendments to IFRS 4 and paragraphs 104–106 and C1A–C1B of the [Draft] amendments to IFRS 16)

Paragraphs 6.9.2–6.9.6 of the draft amendments to IFRS 9 propose that:

a) *a financial asset or financial liability would be modified if the basis for determining the contractual cash flows is changed after the initial recognition of the financial instrument. In this context, a modification can arise even if the contractual terms of the financial instrument are not amended.*

b) *an entity would apply paragraph B5.4.5 of IFRS 9 as a practical expedient to account for a modification of a financial asset or financial liability that is required by interest rate benchmark reform.*

c) *a modification is required by interest rate benchmark reform if and only if*
   i. *it is required as a direct consequence of interest rate benchmark reform; and*
   ii. *the new basis for determining the contractual cash flows is economically equivalent to the previous basis (ie the basis immediately preceding the modification).*

d) *an entity would also apply the practical expedient proposed in paragraph 6.9.3 if an existing contractual term is activated that results in a change in the basis for determining the contractual cash flows of a financial asset or a financial liability, and particular other conditions are met.*

Paragraphs BC10–BC36 of the Basis for Conclusions describe the Board's reasons for these proposals.

e) *The Exposure Draft proposes to make corresponding amendments to IFRS 4 that would require insurers applying the temporary exemption from IFRS 9 to apply the same practical expedient as described above.*

f) *The Exposure Draft proposes amendments to IFRS 16 that would require entities to apply paragraph 42 of IFRS 16 to account for a lease modification that is required by interest rate benchmark reform.*

Paragraphs BC39–BC41 and paragraphs BC118–BC125 of the Basis for Conclusions describe the Board's reasons for these proposals.

Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose and why.

Modification without amendment to contractual terms

We agree with the Board's proposal that, in the context of IBOR reform, a modification can arise even if the contractual terms of the financial instruments are not amended. However, we are of the view that, for example, the exercise of an option in a contract could be construed as being the activation of a contractual term, which we understand is not what the IASB is contemplating when it refers to circumstances in which a modification can arise even if the contractual terms of the financial instruments are not amended for the purposes of the proposal. We therefore suggest that the IASB amends the proposal to clarify this point so to minimise unintended consequences.

Applying B5.4.5 of IFRS 9 as a practical expedient

We agree with the proposal of applying B5.4.5 of IFRS 9 as a practical expedient to account for a modification of a financial asset or financial liability that is required by interest rate benchmark reform, because this will provide more useful information to users of financial statements and provide practical relief for preparers. As noted in BC26, not updating the interest rate benchmark-based effective interest rate (EIR) to the alternative benchmark does not reflect the economic effects of the modified financial instrument, and maintaining the original EIR could be difficult if not impossible when that rate is no longer available.

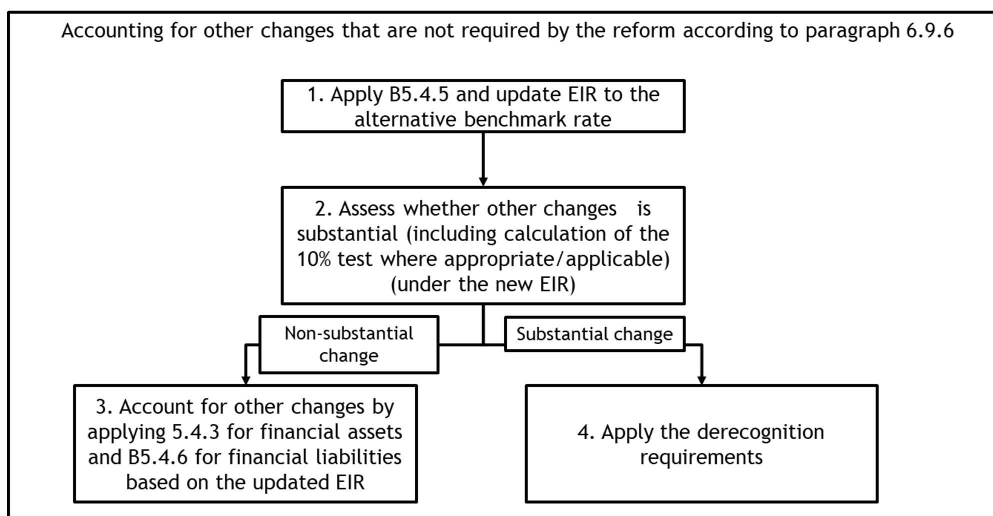
Modification that involves other changes not required by reform

There appears to be an inconsistency between paragraph 6.9.6 of the ED and BC 35 in relation to how modifications that also include other changes not required by the reform are to be accounted for, and which EIR to use for the 10% test to assess whether other changes are substantial.

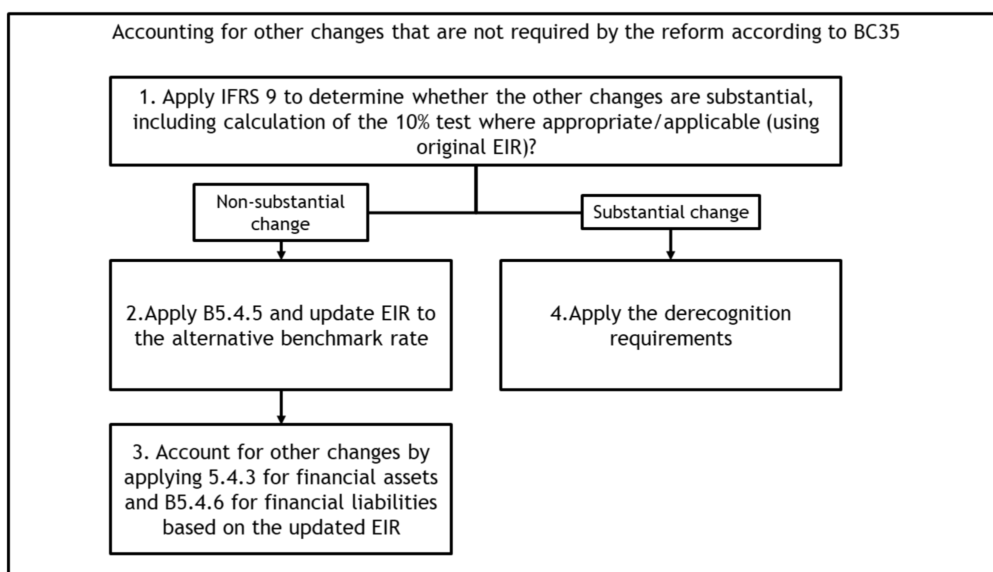
Our understanding of paragraph 6.9.6 of the ED is as follows:

1. First apply the practical expedient and update EIR to the alternative benchmark
2. Assess whether other changes are substantial (this would include performing the 10% test using the updated EIR where relevant/applicable)
3. If non-substantial, account for other changes by applying for IFRS 9.5.4.3 financial assets and IFRS 9.B5.4.6 for financial liabilities.

The diagram below depicts this pictorially to facilitate understanding of our point:



However, upon reading BC35, it appears that an entity should consider whether other changes are substantial first (which by implication would mean performing the 10% test where applicable using the original EIR), and then apply the practical expedient for interest rate benchmark reform.



Based on our reading of Staff Paper AP14A from the September 2019 IASB Meeting, and from the October 2019 IASB Update, it appears that the IASB and staff had intended the order in which it is stated in paragraph 6.9.6 of the ED to be applied. We therefore, recommend the wording in BC35 be amended to be consistent with that of paragraph 6.9.6.

In addition, we agree with paragraph 46 of Staff Paper AP14A from the September 2019 IASB Meeting, that adding an illustrative example to IFRS 9 to demonstrate the order of accounting when modifications involve other changes in addition to those required by interest rate benchmark reform would be useful. This is because the addition of such an illustrative example would assist in providing clarity as to the way in which the modification principles in IFRS 9 and the proposed practical expedient are to be applied and to ensure consistency of application.

Location of the practical expedient to be incorporated into IFRS 9

We note that the proposed practical expedient for the modification of financial assets and liabilities is currently proposed to be incorporated in to Chapter 6 of IFRS 9 as paragraphs 6.9.1-6.9.6 under the ED. However, we believe that for an entity that chooses as its accounting policy to continue to apply the hedge accounting requirements of IAS 39 instead of the requirements in Chapter 6 of IFRS 9, that it will not be possible for the entity to apply the proposed practical expedient for modification of financial assets and liabilities. This is because the practical expedient is included in Chapter 6 of IFRS 9 (which is required not to be applied if an entity decides on transition to continue to apply the hedge accounting requirements of IAS 39 – see IFRS 9.7.2.21), and no equivalent practical expedient is included in IAS 39 in the ED.

The proposed practical expedient for the modification of financial assets and liabilities would therefore be better placed if it is incorporated into Chapter 3 of IFRS 9 instead. We note that the related modifications guidance for financial liabilities as well as the recognition and derecognition requirements for financial assets and liabilities are located in that chapter.

Proposed amendments to IFRS 16

We suggest that in paragraph 105 that the Board also makes reference to IFRS 16.43 as well as to IFRS 16.42. This is because moving to the alternate benchmark rate would require the lease payments to be updated to reflect the alternate benchmark (IFRS 16.42) as well as updating the discount rate (because the change in lease payments result from a change in floating rates (IFRS 16.43)). We note from Staff Paper 14B from the January 2020 IASB Meeting (paragraph 18), the staff had noted that an entity should apply IFRS 16.42(b) and paragraph 43 of IFRS 16. In addition the IASB January Update also make specific reference to paragraph 42(b) and 43 of IFRS 16:

"… to require a lessee to apply paragraphs 42(b) and 43 of IFRS 16 to account for lease modifications to the interest rate benchmark on which lease payments are based that are required as a direct consequence of IBOR reform and done on an economically equivalent basis (modifications directly required by IBOR reform). …"

Question 2*—Amendments to hedging relationships (paragraphs 6.9.7–6.9.10 of the [Draft] amendments to IFRS 9 and paragraphs 102O–102R of the [Draft] amendments to IAS 39)*

Paragraphs 6.9.7–6.9.10 of the draft amendments to IFRS 9 and paragraphs 102O–102R of the draft amendment to IAS 39 propose that an entity would amend the formal designation of the hedging relationship only to make one or more of the changes specified in paragraph 6.9.7 and paragraph 102O as and when uncertainty arising from interest rate benchmark reform is no longer present with respect to the hedged risk and/or the timing and the amount of interest rate benchmark-based cash flows of the hedged item or of the hedging instrument.

Paragraphs BC42–BC50 of the Basis for Conclusions describe the Board's reasons for these proposals.

Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose and why.

We agree with the proposals to amend the hedge accounting designation documentation so that changes can be made to the hedged risk, the hedged item and hedging instrument without causing a discontinuation of the hedge relationship.

However we note that, in some cases, where changes are made as a result of interest rate benchmark reform, entities may need to make adjustments for instances where a portion or layer of the hedged item is being hedged. Such a change may arise, for example, by the addition of a fixed spread to compensate for a basis difference between an existing interest rate benchmark and an alternative benchmark rate, which could give rise to the need to revise the amount hedged. It is not clear whether the Board envisages that such adjustments are already permitted under the existing rebalancing requirements in IFRS 9, where rebalancing is accounted for as a continuation of the hedging relationship (IFRS 9.B6.5.8). If this is case, we suggest that the IASB makes this clear in the final amendments in order to minimise inconsistency in practice.

We also note that similar provisions do not exist in IAS 39. We therefore suggest that the IASB also provides an exception as part of these set of proposals to allow similar adjustments to portions or layers being hedged in its amendment to IAS 39.

Question 3*—Accounting for qualifying hedging relationships and groups of items (paragraphs 6.9.11–6.9.15 of the [Draft] amendments to IFRS 9 and paragraphs 102S–102X of the [Draft] amendments to IAS 39)*

Paragraphs 6.9.11–6.9.15 of the draft amendments to IFRS 9 and paragraphs 102S–102X of the draft amendments to IAS 39 propose that:

a) the requirements in IFRS 9 and IAS 39 would be applied when the designation of a hedging relationship is amended to remeasure the hedging instrument and the hedged item based on the alternative benchmark rate and recognise any resulting ineffectiveness in profit or loss

b) the amount accumulated in the cash flow hedge reserve at the date the entity amends the description of the hedged item would be deemed to be based on the alternative benchmark rate on which the hedged future cash flows are determined.

c) when there is a change in the basis for determining the contractual cash flows of a financial asset or a financial liability previously designated as a hedged item in a hedging relationship that has been discontinued, the amount accumulated in the cash flow hedge reserve for the discontinued hedging relationship would be deemed to be based on the alternative benchmark rate on which the hedged future cash flows will be based.

d) when applying paragraph 6.9.7 or paragraph 102O to groups of items designated as hedged items, the hedged items would be allocated to sub-groups within the same hedging relationship based on the benchmark rate to which they are referenced and that the proportionality test would be applied to each sub-group separately.

e) for the purpose of assessing retrospective effectiveness as required by IAS 39, the cumulative fair value changes of the hedged item and hedging instrument would be reset to zero when paragraph 102G of IAS 39 ceases to apply.

Paragraphs BC51–BC79 of the Basis for Conclusions describe the Board's reasons for these proposals.

Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose and why.

We agree with the proposals to require remeasurement of the hedging instrument and the hedged item based on the alternative benchmark at the amendment date, with any resulting ineffectiveness being recognised in profit or loss.

We also support the Board’s proposals:

- That the amount remaining accumulated in the cash flow hedge reserve at the amendment date should be based on the alternative benchmark rate on which the hedged future cash flows are determined.
- To allocate groups of items to sub-groups as it provides a practical way to address the challenges of when individual items within the group move on to the alternative benchmark rate at different times.
- To reset the cumulative fair value changes of the hedged item and hedging instrument to zero for the purposes of retrospective effectiveness testing under IAS 39.

Question 4*—Designation of risk components and portions (paragraphs 6.9.16–6.9.18 of the [Draft] amendments to IFRS 9 and paragraphs 102Y–102Z1 of the [Draft] amendments to IAS 39)*

Paragraphs 6.9.16–6.9.18 of the draft amendments to IFRS 9 and paragraphs 102Y–102Z1 of the draft amendments to IAS 39 propose that:

a) an alternative benchmark rate designated as a non-contractually specified risk component that is not separately identifiable at the date it is designated, would be deemed to have met that requirement at that date, if and only if, the entity reasonably expects the alternative benchmark rate will be separately identifiable within a period of 24 months from the date the alternative benchmark rate is designated as a risk component.

b) if subsequently, an entity reasonably expects that the alternative benchmark rate will not be separately identifiable within 24 months from the date it was designated as a risk component, an entity would cease applying the requirement in paragraph 6.9.16 and paragraph 102Y and discontinue hedge accounting prospectively from the date of that reassessment.

Paragraphs BC87–BC97 of the Basis for Conclusions describe the Board's reasons for these proposals.

Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose and why.

We agree with the IASB's proposal to provide an exemption for meeting the separately identifiable criterion only and not the reliably measurable criterion. However, we suggest that the Board clarifies, in the final amendments, the distinction between 'separately identifiable' and 'reliably measurable'. Whilst these are two distinct concepts, they are often discussed together in IFRS 9, and the difference between the two is not always well understood.

When identifying whether a risk component is separately identifiable, IFRS 9 requires an assessment within the context of the particular market structure to which the risk relates and in which the hedging activity takes place. In the earlier phases of the benchmark reform, it may take time for a market structure to be established in order to determine whether the risk is identifiable in pricing fixed rate debt instruments. As noted by the IASB in BC87 and 89, there needs to be sufficient debt instruments referenced to the alternative benchmark rate in order for a market structure to be established. Therefore whether the alternative benchmark rate is a separately identifiable risk component of the fair value of the fixed rate debt instrument may not be established in the initial phases of benchmark interest rate reform. In some cases it may take time to establish that the price of fixed-rate debt instruments varies directly in response to changes in the alternate benchmark rate. However, whilst it may not be possible to establish that the alternative benchmark rate meet the separately identifiable criteria in a fair value hedge of a fixed interest rate debt instrument, there are circumstances where the alternative benchmark rate risk component could be measurable, for example where a forward rate curve of the alternative benchmark is published by the central bank. Therefore, although the terms 'separate identifiable' and 'reliably measurable' are often used together, they are distinct concepts.

Question 5*—Effective date and transition (paragraphs 7.1.9 and 7.2.36–7.2.38 of the [Draft] amendments to IFRS 9 and paragraphs 108H–108J of the [Draft] amendments to IAS 39)*

a) The Exposure Draft proposes that the amendments would have an effective date of annual periods beginning on or after 1 January 2021. Earlier application would be permitted.

b) The Exposure Draft proposes that the amendments would be applied retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, except as specified in (ii) below. An entity would:

   i. reinstate a discontinued hedging relationship if and only if the entity discontinued that hedging relationship solely due to changes required by interest rate benchmark reform and, therefore, the entity would not have been required to discontinue that hedging relationship if the amendments had been applied at that time.

   ii. not be required to restate prior periods to reflect the application of these amendments. However, the entity may restate prior periods if, and only if, it is possible without the use of hindsight.

Paragraphs BC110–BC115 of the Basis for Conclusions describe the Board's reasons for these proposals.

Do you agree with these proposals? Why or why not? If you agree with only parts of the proposals, please specify what you agree and disagree with. If you disagree with the proposals, please explain what you propose and why.

We agree with the proposed effective date and encourage the IASB to move forward quickly to completion of the final standard so that the amendments can be applied early by entities which have already begun their transition to the alternative interest rate benchmarks.

However, rather than requiring entities to restate previously discontinued hedges due to interest rate benchmark reform under paragraph 7.2.37 of IFRS 9 and paragraph 108I of IAS 39, we think the amendments should allow entities to make an accounting policy choice of whether to reinstate previously discontinued hedging relationships for all hedging relationships that were discontinued solely due to changes required by interest rate benchmark reform from the date on which the first discontinued hedging relationship was reinstated. For example, if an entity discontinued three hedging relationships solely due to changes required by interest rate benchmark reform on 12 October 2018, 17 November 2018 and 5 May 2019 and elects to reinstate the hedging relationship that was discontinued on 17 November 2018, then it should also be required to reinstate the hedging relationship that was discontinued on 5 May 2019 as well. This would provide further practical operational relief for entities dealing with changes of interest rate benchmark reform if they choose not to reinstate hedge accounting while maintaining some rigour into the requirements to prevent entities from 'cherry picking' which of their previously discontinued hedge relationships to reinstate.

Question 6*—Disclosures (paragraphs 24I–24J and paragraphs 44HH–44II of [Draft] amendments to IFRS 7) The Exposure Draft proposes that entities provide specific disclosures in order to provide information about:*

a) the nature and extent of risks arising from interest rate benchmark reform to which the entity is exposed, and how it manages those risks; and

b) the entity's progress in completing the transition from interest rate benchmarks to alternative benchmark rates, and how the entity is managing that transition.

Paragraphs BC105–BC109 of the Basis for Conclusions describe the Board's reasons for this proposal.

Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you propose and why.

We agree that the proposed disclosures would provide useful information to users of financial statements.

However, in addition to these proposed disclosures, in order to understand the effect of interest rate benchmark reform on an entity's hedging relationships, the Board may consider requiring disclosure of the fair value of the hedging instruments and the hedged item for those hedge relationships that are affected by interest rate benchmark reform.